Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Frommer | Analyst: Gail Hall | Bill Number: AB 1037

Related Bills: See Legislative History | Telephone: 845-6111 | Amended Date: 4/7/2005 and 4/12/2005

Attorney: Patrick Kusiak | Sponsor: ______

SUBJECT: Net Receipts In Sales Factor For Treasury Function & Security Institutions

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended __________________.

_____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ____________________.

__X__ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO ____________________.

_____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ____________________________ STILL APPLIES.

X OTHER – See comments below.

SUMMARY

Under the Corporation Tax Law, this bill would provide a definition of gross receipts.

SUMMARY OF AMENDMENTS

The April 12th amendments removed a paragraph relating to registered securities or commodities brokers or dealers.

The April 7th amendments added that "gross receipts" from a treasury function activity is limited to "net receipts." This item is discussed further in the ANALYSIS discussion below. The department's analysis of the bill as introduced on February 22, 2005, no longer applies.

PURPOSE OF THE BILL

The author's office has indicated the purpose of this bill is to define a previously undefined term in order to prevent potential manipulation of the franchise tax apportionment formula.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR		
_______ N	_______ OUA	_______ PENDING		

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment, and if enacted in 2005, it would be operative for taxable years beginning on or after January 1, 2005.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The issues discussed in this bill are not applicable to federal law because the federal method of taxation is different from the California method.

California has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with certain modifications, to determine how much of a taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise tax. UDIPTA uses an apportionment formula to determine the amount of "business"[1] income attributable to California.

"Business" income attributable to California is a taxpayer's business income multiplied by its California apportionment formula. The apportionment formula consists of property, payroll, and sales factors. The property factor includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor is double weighted and generally includes all gross receipts from the sale of tangible and intangible property. The calculation of the apportionment formula and California business income is illustrated below:

$$\frac{\boxed{\text{Average } \frac{\textbf{CA Property}}{\text{Average Total Property Everywhere}}} + \boxed{\frac{\textbf{CA Payroll}}{\text{Total Payroll Everywhere}}} + \left(2 \text{ X} \boxed{\frac{\textbf{CA Sales}}{\text{Total Sales Everywhere}}}\right)}{4} = \text{California Apportionment Formula}$$

X Total Business Income
= California Business Income

1 Revenue & Taxation Code (R&TC) Section 25120(a) defines business income as income arising from or an integral part of the activities of a trade or business. Nonbusiness income is all income other than business income.

The sales factor is defined as a taxpayer's total California sales divided by a taxpayer's total sales everywhere.[2] Sales are defined as all gross receipts of the taxpayer except for certain nonbusiness income.[3] California law does not provide a definition for gross receipts.

Sales from intangible assets are categorized as California sales if the greater portion of the activities that produced the sales is performed in California.[4] Generally, treasury function activities[5] are performed at the headquarters of the taxpayer.

THIS BILL

This bill would limit gross receipts from a treasury function activity to the overall net gain for the calculation of the California sales factor. This bill provides the following definitions:

1. "Treasury function" means the pooling, management, and investment of liquid assets for the purpose of satisfying the cash flow needs of a business.

2. "Liquid asset" means a readily marketable intangible. Examples are stocks, bonds, debentures, options, warrants, futures contracts, foreign currency, mutual funds that hold those intangibles, and repurchase arrangements relating to such intangibles. An intangible is considered marketable if it is traded in an established stock or securities exchange or market and is regularly quoted by brokers or dealers.

This bill provides that an equity interest in a business, such as stock in a corporation, is not a marketable intangible if there is a unitary or substantial business relationship.

IMPLEMENTATION CONSIDERATIONS

This bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

1. To ensure that the amendments made by the bill do not inadvertently change state law for securities brokers as reflected in the *Appeal of Merril, Lynch*, *Pierce, Fenner, & Smith, Inc*. (Cal. St. Bd. Of Equal., June 2, 1989,) language should be added to explain that the definition of gross receipts for the treasury function will not apply to taxpayers that are in the business of buying and selling intangible assets. See attached Amendment 1.

2. The reference "section 38006" should be expanded to provide that it is located in Part 18. See attached Amendment 2.

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2 R&TC Section 25134.

3 R&TC Section 25120(e)

4 R&TC Section 25136

5 A taxpayer's treasury function activities are investments in intangible assets such as stocks, bonds, and certificates of deposit, for the purpose of satisfying a taxpayer's cash flow needs.

3. To ensure that the amendments made by the bill include comprehensive definitions for treasury function activities, language should be added to include repurchase arrangements in the definition of a “liquid asset” since those transactions may be a significant activity of the treasury function. See Attached amendment 3.

LEGISLATIVE HISTORY

R&TC Section 25120 (Stats. 1966, Ch. 2) was added as part of California’s adoption of UDIPTA. It provides definitions for terms used in the apportionment and allocation of income derived from sources within and without California. The objective of UDIPTA was to provide for a uniform method for allocating income between states.

BACKGROUND

Although the concept behind the sales factor is relatively straightforward, the application of the rules to specific sales can be complicated.

For several years, some taxpayers, based in states other than California, have taken the position that the California sales factor includes gross receipts from the trading or redemption of intangible assets, and therefore, include these gross receipts in the denominator of the California sales factor. This position reduces a taxpayer’s California sales factor, apportionment percentage, and tax liability.

Since “gross receipts” is not defined in the current state law, questions arise whether a certain activity should be included in the sales factor. These activities often have material tax consequences. With respect to a treasury function, the department has two arguments:

1. If a debt instrument is held to maturity, the return of the principal amount of the underlying security is not a “gross receipt,” and therefore, should not be included in the sales factor.
2. If it is determined that the return of principal does constitute a receipt for sales factor purposes, including such a transaction in the sales factor does not fairly reflect a taxpayer’s activity in California.

Below are two examples that illustrate the tax consequences of treasury function activities.

<u>Example 1</u>

Assume a taxpayer, doing business in California but headquartered in Montana, purchases a one-year CD for $100,000 with a rate of 10%. At the end of the year, the CD matures and the taxpayer receives $110,000. ($100,000 of principal and $10,000 of interest). The taxpayer has California sales of $250,000, and sales everywhere of $500,000 from its core business activity without taking into account the interest earned on the CD because of its maturing. If the taxpayer takes the position that $110,000 relating to the CD belongs in the denominator of the sales factor, the California sales factor is calculated as 41%; whereas, under this bill the taxpayer includes $10,000 in the denominator of the sales factor, the California sales factor is 49%. The results of this example are shown below:

Sales Factor Using Gross Receipts	Sales Factor Using Net Receipts
$250,000 / $610,000 = 41% ($500,000+$110,000)	$250,000 / $510,000 = 49% ($500,000+$10,000)

The above example illustrates how including gross, instead of net, receipts in the denominator of the sales factor, reduces the California sales factor percentage when a taxpayer's headquarters are located out of state. The above example was kept simple, but if a taxpayer's treasury function activities involve large dollar amounts and numerous securities that mature and are reinvested throughout the year, including return of principal amounts in the sales factor could significantly reduce the California sales factor.

Example number one deals with an intangible asset that was held to maturity, but the gross receipts issue also affects the sales factor for transactions involving the sale of stock and the sale of intangible assets before maturity.

Example 2

Assume a large corporation headquarted in Arizona, has California sales from its core business activities of $ 20 million, and sales everywhere from its core business activities of $100 million. The taxpayer also has gross receipts from the daily purchase and sale of intangible assets, a treasury function, totaling $10 billion and net income from these sales totaling $10 million. If the taxpayer takes the position that $10 billion belongs in the denominator of the sales factor, the sales factor is calculated as .2%; whereas, under this bill, if the taxpayer includes $10 million in the denominator of the sales factor, the sales factor would be 18%. The results of this example are shown below:

Sales Factor Using Gross Receipts	Sales Factor Using Net Receipts
$ 20,000,000 / $10,100,000,000 = .2% ($100 billion + $100 million)	$ 20,000,000 / $ 110,000,000 = 18% ($100 billion +$10 million)

Example 2 illustrates how treasury function activities, such as the purchasing and selling of intangible assets, may significantly reduce the California sales factor if the taxpayer's headquarters is located out of state. In this example, 20% of the taxpayer's sales are in California, ($20 million/$100 million), yet the California sales factor is only .2% if the taxpayer includes "gross" receipts in the sales factor. Including "gross" receipts in the sales factor may significantly distort the sales factor and not fairly represent the taxpayer's actual business activities in California.

<u>Pending Court Cases</u>

1. In *General Motors Corporation v. Franchise Tax Board (2004),* the California Court of Appeal (Second District) affirmed the department's exclusion from the sales factor the principal portion of certain gross receipts from investments in bonds, notes, bills, and CD's that bore maturity dates and returned both principal and interest to the taxpayer. The California Supreme Court has accepted review of this case; therefore, the court of appeal decision has been vacated.

2. On February 28, 2005, the California Court of Appeal (First District) in *Microsoft Corporation v. Franchise Tax Board,* issued an unpublished opinion holding that inclusion of the receipts described by this bill in the denominator of the sales factor did not fairly reflect the company's activilty in California. There are two other cases pending at the appellate level where the position of the Franchise Tax Board was sustained at the trial level.

OTHER STATES' INFORMATION

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

General research was performed to determine how these states define "gross receipts." *Minnesota*, *Michigan*, *Massachusetts*, *New York*, and *Florida* exclude treasury transactions in the definition of "gross receipts," and Illinois includes the net gains from the treasury transactions in "gross receipts."

<u>*Florida*</u> - The term "sales" means all gross receipts received by the taxpayer from transactions and activities in the regular course of its trade or business, except interest, dividends, rents, royalties, and gross receipts from sale, exchange, maturity, redemption, or other disposition of securities.

<u>*Illinois*</u> - Sales of intangibles: Gross receipts from the sales of business intangibles, such as patents, copyrights, bonds, stocks, and other securities, are disregarded and only the net gains or losses are included in the sales factor.

<u>*Massachusetts*</u> - The sales factor is a fraction, the numerator of which is the total sales of the corporation in that commonwealth during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. As used in that law, "sales" means all gross receipts of the corporation except interest, dividends, and gross receipts from the maturity, redemption, sale, exchange, or other disposition of securities.

<u>*Michigan*</u> - "Sales" includes gross receipts from the sales of tangible property, from the rental of property and from providing services provided as part of the taxpayer's business activity (such as legal or accounting services).

Minnesota - The sales factor includes *all* sales, gross earnings, or receipts received in the ordinary course of the business, *except* interest, dividends, sales of capital assets, sales of property used in the trade or business, and sales of stock and debt instruments.

New York – A treasury function receipt from the sale of a capital asset is not a business receipt and is not includable in the receipts factor. New York has not adopted UDIPTA.

The *Multistate Tax Commission* has adopted two regulations that accord the receipts described in this bill the same treatment.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Revised Estimated Cash-Flow Impact of AB 1037 ($Millions) Effective for tax years beginning on or after 1/01/2005 Enacted after 7/01/2005			
Fiscal Years	2005-06	2006-07	2007-08
	$95	$90	$0

Revenue Discussion

The revenue impact of the treasury function issue was estimated in three steps. Since the treasury function issue is associated mostly with large, apportioning out-of-state corporations, all corporations that met the following conditions for the 2001 tax year were identified:

1. taxable income greater than $5 million,
2. headquarters outside of California,
3. income apportioned to California, and
4. gross receipts (as reported on line 1C of Schedule F, Computation of Net Income, Form 100) are less than 90% of gross sales (the denominator of the sales factor as reported on Schedule R, Apportionment and Allocation of Income, Form 100).

About 300 corporations met the above conditions. The preliminary revenue impact of the proposed law is estimated by re-computing the tax liability using the new apportioning factor in which the denominator of the sales factor is replaced with gross receipts.

Next, the top 50 of these corporations were evaluated using the department's tax audit cases to identify the revenue impact due to treasury function issues for each corporation.

Finally, the result of this evaluation was adjusted upward to account for the remaining 250 corporations, including the corporations that did not include Schedule F or Schedule R with their tax returns.

The 2001 revenue estimate is extrapolated into future years based on the Department of Finance's projection of corporate profits.

It should be noted that the revenue impact of the treasury function issue reflects only a short-term cash-flow gain. The reason for this is that the department assumes that its interpretation of the law regarding the treasury function issue is correct. Therefore, regardless of how taxpayers file, the use of gross receipts in the denominator of the sales factor for the treasury function will ultimately be disallowed. The impact of this bill would be to provide certainty and to accelerate the cash flow related to the treasury function. This revenue would, under this bill, come into the state during the fiscal year when the taxpayer makes estimated and final payments, as opposed to several years later after an audit has been completed and the administrative dispute resolution process is final.

LEGISLATIVE STAFF CONTACT

Gail Hall
Franchise Tax Board
(916) 845-6111
gail.hall@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov

Analyst: Gail Hall
Telephone#: 845-6111
Attorney: Patrick Kusiak

FRANCHISE TAX BOARD
PROPOSED AMENDMENTS TO AB 1037
As Amended April 12, 2005

AMENDMENT 1

On page 3, after line 10, insert:

(3) Paragraph (2) shall not apply to a person principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets.

AMENDMENT 2

On page 2, line 22, after “38006” insert:

of Part 18 (commencing with Section 38001),

AMENDMENT 3

On page 2, lines 33,34, and 35, the following amendments should be made:

(ii) “Liquid asset” means a readily marketable intangible, including, but not limited to, stocks, bonds, debentures, options, warrants, futures contracts, foreign currency, ~~and~~ mutual funds that hold those intangibles, and repurchase arrangements relating to such intangibles.